# Chart of the Month

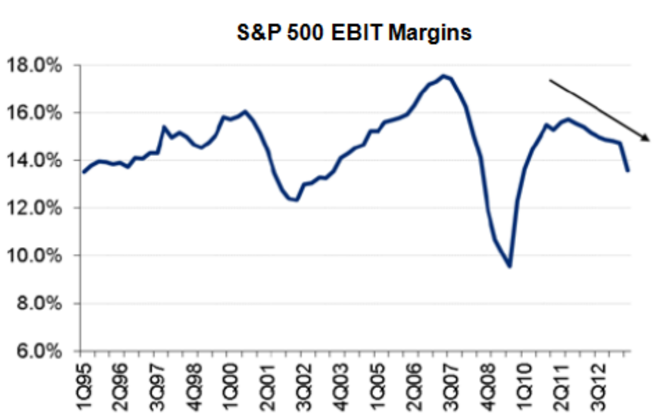
October 2013


As shown in the graph above, corporate profits as a percentage of GDP (Gross Domestic Product) have been in a secular uptrend for more than two decades with a significant cyclical improvement since the last recession. The growth in profits relative to the size of the economy is attributable to the expansion in net margins over the past three upturns.

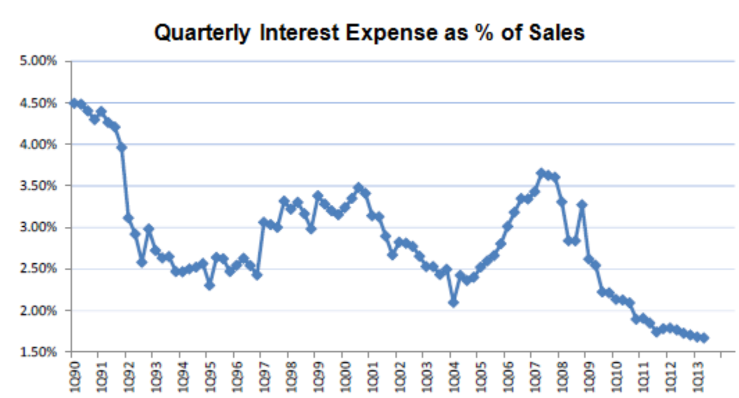
While the general perception is that net margins have been increasing due to gains in productivity, the reality is that the rise in profitability owes as much or more to lower effective tax rates and interest expense as it does cost cutting and enhanced output. To illustrate, as detailed in the graph at the bottom right, interest expense as a percentage of sales has fallen from 4.50% in 1990 to less than 1.70% in 2013 with the preponderance of the drop taking place during the past five years. Meanwhile, as displayed at the bottom left, EBIT (earnings before interest and taxes) margins have rolled over, confirming that the recent achievements in profits have come less from operations than other factors.

Like homeowners, corporations have been refinancing their debt. These companies have benefited by lowering interest costs and extending maturities. The combination allows them to service their debt at a cheaper rate for a longer time. The reduced interest expense increases profits by a like amount as the gains fall directly to the bottom line.

In conclusion, companies have been as adept at managing taxes and balance sheets as their underlying businesses. In fact, by one estimate, corporate savings on interest expense has accounted for nearly 50 percent of the growth in EPS for the S&P 500 since the end of 2009.




Source: FactSet and Citi Research





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